MAGNUS FINANCIAL GROUP

INSIGHT & PERSPECTIVE
An Eye On Liquidity

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Central Banks Pull Back on Accommodative Policies

The Federal Reserve appears steadfast in its resolve to return monetary policy to levels of normalization.

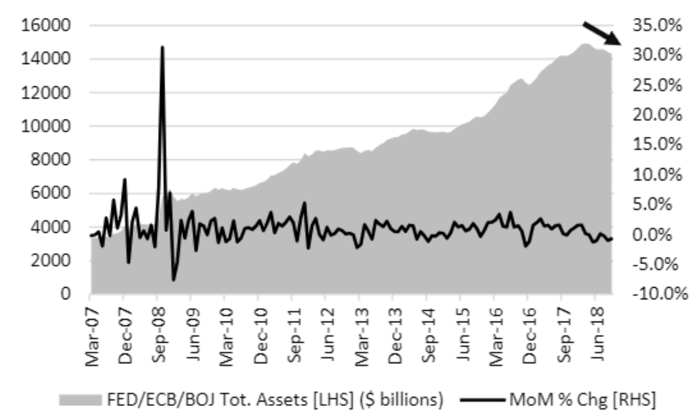
The European Central Bank is some steps behind the Fed, but the ECB has so far not wavered from its intended path back to a tighter policy.

It seems to us that the directional change in monetary policy is underway, and we believe it is often directional change which drives the market's sentiment over asset prices.

Market participants have likely had it in the back of their minds for years...that is, the time when central banks would begin to sustainably reduce their unprecedented policy accommodation. Well, that time has evidently arrived, and it has brought with it a period of unease for financial markets. In our view, this was to be expected. Just as central banks offered markets a foundation of stability during the post-crisis years, it stands to reason that removal of that historic support would leave investors concerned over the market's ability to stand on its own. While economic and other fundamentals today are indeed favorable, in our view, investors may be more focused on the directional change in liquidity authored by central bank tightening and what that means for forward conditions.

Meanwhile, central bankers, particularly the Federal Reserve, have given only a modest nod to the recent tumult in financial markets and some sluggishness in recent economic numbers. In fact, Federal Reserve Chairman Jerome Powell indicated he believes Fed policy is still below neutral, which may necessitate further tightening through 2019 and may consequently produce additional market angst. The European Central Bank, meanwhile, has moved ahead with plans to reduce its balance sheet, and the current consensus expects the ECB to begin raising its benchmark rate in mid/late 2019. Even Bank of Japan has allowed its balance

Figure 1: Fed / ECB / BoJ - Total Assets and MoM % Chg.
Source: Federal Reserve, European Central Bank, Bank of Japan



sheet to shrink in recent months. As such, key central bankers seem intent on returning to some normalization of monetary policy; a readiness plan that may prepare economies for the next downturn.

While central bank balance sheets have begun to shrink (accomplished by reduction/elimination of bond purchases and not reinvesting proceeds from matured holdings), the average interest rate policy has also been on the rise (Figure 2). This has been largely driven by the Fed's tightening, but the ECB is also expected to follow suit in the quarters ahead. So while global monetary policy still remains highly accommodative, the directional change in policy action and tone has caused investors to raise the rate at which risky assets are discounted out into the future. These mathematics can contribute to a reduction in the price equity investors are willing to pay for market exposure. As markets search for a new price equilibrium, higher periods of volatility often ensue.

Figure 2: Fed / ECB / BoJ / BoE - Policy Rate Average (%)

Source: Federal Reserve, European Central Bank, Bank of Japan, Bank of England

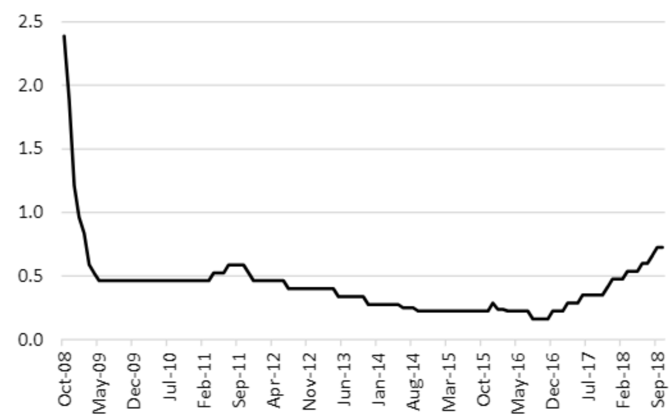
Number of benchmark rate increases since the 2016 low:

Fed: 7

ECB: 0

BoE: 2

BoJ: 0



More Evidence in the U.S. Monetary Base

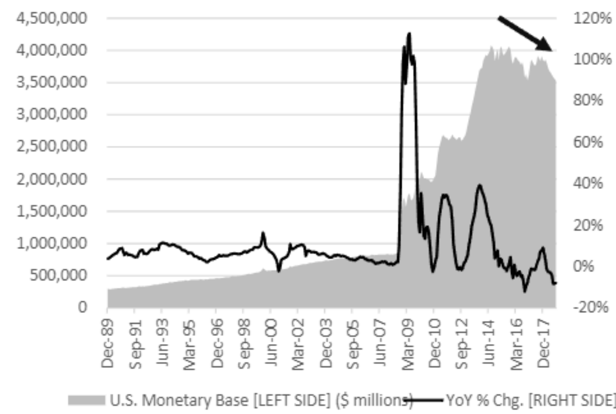
Since the financial crisis, Federal Reserve policy has contributed to a substantial lift in the U.S. monetary base (Figure 3, next page). Some credit the monetary rise for pushing up the valuation of equity and other risky asset prices around the world. We agree that in addition to the post-crisis improvement in fundamentals the sustained, easy monetary policy has provided considerable asset price support. Going forward, however, some key questions this market will deal with are likely the following: 1.) How much of the rise in asset prices can be attributed to monetary policy? And… 2.) What will the reduction in liquidity do to asset prices? In our view, there is no certain answer to the first question. But we do believe that a reduction in liquidity will take some air out of asset prices...the exact amount of air remains to be seen.

For market participants, the message in the recent central bank and monetary base data is that the unusual period of policy accommodation has now begun to turn, and investors should prepare their portfolios for that directional change in policy. Why? Because we believe the mantra "Don't Fight the Fed" applies to both accommodative and restrictive monetary policy. This does not mean investors should engage in the wholesale selling of risky assets, but is does mean that those in the market should step a little lighter in terms of risk-taking. While further policy tightening could generate additional bouts of market uncertainty, we believe the monetary navigating is necessary to stockpile resources for the next economic downturn that will inevitably come.

Monetary Base - Sum of currency in circulation outside of Fed banks, plus deposits held by depository institutions at Fed banks.

Figure 3: U.S. Monetary Base and YoY % Chg.

Source: Federal Reserve



Questions?

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